

## It Better Only Drizzle

### *Why the newly created Oregon Rainy Day Fund is inadequate protection against the next economic downturn and how the problem can be fixed*

Despite the creation of the Oregon Rainy Day Fund by the Legislature earlier this year, Oregon's public structures remain exposed to serious disruption in the next, inevitable economic downturn. This report examines the severe shortcomings of Oregon's two reserve accounts, the Rainy Day Fund and the Education Stability Fund, finding that:

- As of October 2007, state reserves available to the Legislature in the new Rainy Day Fund and the Education Stability Fund, combined, total only \$237 million — the equivalent of just 1.8 percent of General Fund revenue in the current budget cycle. To weather a recession of the same magnitude as the one that struck in 2001, the state would need nearly \$2 billion, or about 15 percent of General Fund revenue in the current budget cycle.
- A design flaw prevents the Legislature from accessing the Oregon Rainy Day Fund until July 2009, and it severely limits access to future earnings and investments in the fund.
- The Education Stability Fund was drained nearly empty in 2005 and has barely recovered. Its effectiveness, moreover, is hampered because some of its funds are tied up in venture capital investments and because investment earnings are not retained in the fund.
- Oregon has failed to fund its two reserve accounts adequately. At the present rate of funding for both the Rainy Day Fund and the Education Stability Fund, total available reserves will grow to just 6.8 percent of General Fund revenue by the end of the 2013-15 budget cycle. By comparison, the 2001 recession caused General Fund revenue to decline by 15.2 percent.

### How to save Oregon's future rainy days

Oregon would be in much better shape to weather a recession if the Legislature were to fix the flaws that restrict the availability and growth potential of the two reserve accounts and to fund them more adequately.

- The Legislature should refer to voters measures that would transfer future unanticipated personal and corporate income tax revenue into the Rainy Day Fund until the fund reaches its funding cap.
- The Legislature should increase the cap to allow the fund to grow large enough to protect Oregon from a 2001-like recession.

## **It Better Only Drizzle**

### ***Why the newly created Oregon Rainy Day Fund is inadequate protection against the next economic downturn and how the problem can be fixed***

by Michael Leachman and Charles Sheketoff

Acknowledging the devastating effect that the 2001 recession had on crucial state services, the Oregon Legislature took an important step in establishing the Oregon Rainy Day Fund earlier this year. The Rainy Day Fund and the Education Stability Fund, created in 2002, now constitute Oregon's protection in case of an economic downturn. Despite its good intentions, the Legislature has fallen well short of its goal, because the combined reserves in the two funds are only a small fraction of what may be needed to ride out the next recession without painful cuts to education, health and other vital services.

As of October 2007, state reserves available to the Legislature in the new Rainy Day Fund and the Education Stability Fund, combined, total only \$237 million — the equivalent of just 1.8 percent of General Fund revenue in the current budget cycle. To weather a recession of the same magnitude as the one that struck in 2001, the state would need nearly \$2 billion, or about 15 percent of General Fund revenue in the current budget cycle. As explained more fully below, there are three main reasons why Oregon is woefully unprepared to weather a 2001-like economic recession.

First, the legislation that created the new Rainy Day Fund prevents the Legislature from having access to any of the money in the fund until July 2009, and it severely limits access to future earnings and investments in the fund.

Second, the Education Stability Fund was drained nearly empty in 2005 and is still in the process of filling back up. Moreover, the Stability Fund's effectiveness is hampered because some of its funds are tied up in venture capital investments and because investment earnings are not retained in the fund.

Third, and most importantly, Oregon has failed to fund its two reserve accounts adequately. This problem is not temporary, but structural. At the present rate of funding for both the Rainy Day Fund and the Education Stability Fund, the total available reserves — those funds that the Legislature may actually tap to meet revenue shortfall needs — will grow to just 6.8 percent of General Fund revenue by the end of the 2013-15 budget cycle. By comparison, the 2001 recession caused General Fund revenue to decline by 15.2 percent.

No one can say with certainty when the next recession will arrive, but as sure as boom is followed by bust, another downturn will come. When the recession does hit, Oregonians may be in for a serious drenching, unless the Legislature responds quickly to fix the severe shortcomings of the state's reserve funds.

### **The "beginning of that biennium" rule locks the Legislature out of the Oregon Rainy Day Fund until July 2009**

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Under current law enacted by the 2007 Legislative Assembly, legislators cannot access any money in the Rainy Day Fund until July 2009. The Rainy Day Fund offers no protection from a recession before that date.

Legislators seeded the Rainy Day Fund with the unanticipated revenue that otherwise would have gone to corporations with Oregon sales of \$5 million or more as part of the 2007 corporate income tax kicker. As a result of this one-time diversion of unanticipated revenue, the fund received a \$319 million credit on September 6, 2007.<sup>1</sup> The funds could not be transferred until the amount was established in the "close of session" forecast released a few days earlier.

HB 2707, the measure that created the Rainy Day Fund, bars access to the money until July 2009. The bill provides that “[t]he Legislative Assembly may not appropriate for any one biennium more than two-thirds of the amount that is in the Rainy Day Fund *at the beginning of that biennium*” (emphasis added).<sup>2</sup> “At the beginning” of the current biennium — July 1, 2007 — the cash balance of the Rainy Day Fund was zero, since the corporate kicker funds had not been credited to the fund. Hence, legislators are locked out of spending from the fund until the beginning of the next biennium on July 1, 2009.

The “beginning of that biennium” rule has, and will continue to have, significant negative consequences. If a recession hits before July 2009 the funds in the new Rainy Day Fund are off-limits. If a recession hits later, the “beginning of that biennium” rule will, as outlined below, continue to limit the fund’s capacity to protect state services.

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### **The “beginning of that biennium” rule delays access to future transfers into the fund, too**

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**The “beginning of that biennium” flaw not only leaves the Legislature with no Rainy Day Fund dollars available to spend until July 1, 2009, but also hampers access in the future.**

For 2007-09 and subsequent biennia, HB 2707 provides that the lesser of the full ending balance or 1 percent of the biennium’s General Fund appropriations will be transferred into the Rainy Day Fund “as soon as possible *after the ending balance for a biennium is determined*” (emphasis added).<sup>3</sup>

The ending balance for a biennium is determined several months after the *next* biennium has begun. For example, the ending balance transfer for 2007-09, if any, will not be credited to the Rainy Day Fund until sometime around March 1, 2010.<sup>4</sup> Because the transfer will not have occurred by the time the 2009-11 biennium begins, legislators will be blocked from spending the ending balance transferred to the Rainy Day Fund until 2011-13.

Thus, the “beginning of that biennium” flaw not only leaves the Legislature with no Rainy Day Fund dollars available to spend until July 1, 2009, but also hampers access to a large portion of the total in the Rainy Day Fund in future biennia.

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### **The Legislature generally will not be able to spend two-thirds of the fund’s balance**

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HB 2707 prevents the Legislature from draining the Rainy Day Fund dry in any one biennium. Specifically, the Legislature can withdraw a maximum of two-thirds of the fund’s balance in any one biennium.<sup>5</sup> This constraint on the Legislature is in addition to HB 2707’s requirement that a three-fifths majority vote is needed to spend funds.

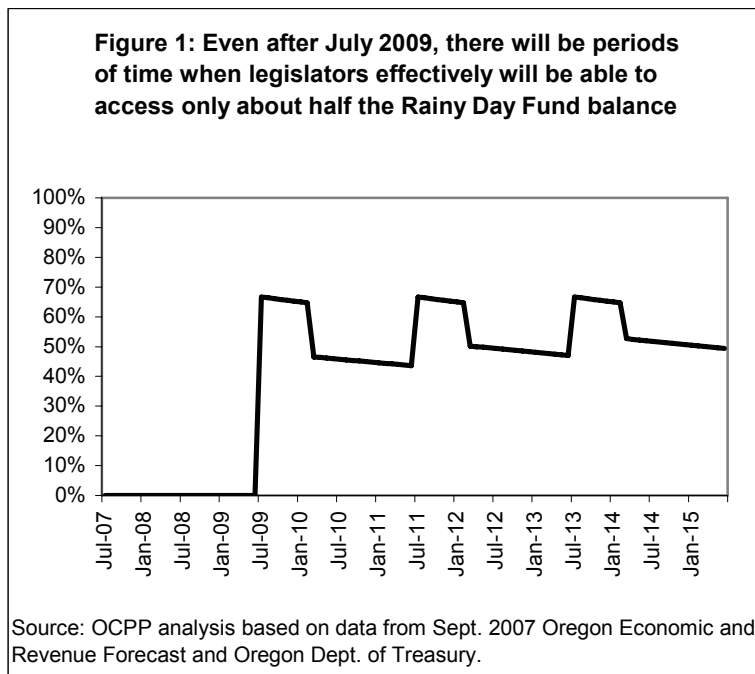
Because HB 2707 also limits spending to the amount in the fund at the beginning of the biennium, legislators will not have access to two-thirds of the total accrued funds for most of each biennium anyway. During brief, one-month interludes at the beginning of each biennium, the Legislature will have access to two-thirds of the total amount in the fund. The share of the fund’s balance accessible to legislators will gradually decline thereafter, because earnings accrued after the beginning of the biennium and the biennial transfers of the ending balance or one percent of appropriations will be off-limits until the start of the subsequent biennium.

In an average month during the 2009-11 biennium, for instance, legislators will have access to only 52 percent of the money in the fund. Here's why:

The fund earns interest monthly. Monthly interest payments made after July 1 in the first month of the biennium will remain off-limits until the start of the subsequent biennium.

Furthermore, as noted above, around March 1 of the first year of each biennium the Rainy Day Fund will receive a new infusion of money – the ending balance or 1 percent of the total appropriations from the prior biennium, whichever is less. These new funds, of course, will not be accessible until the beginning of the next biennium. When the new money is transferred into the fund, the share of the fund's total balance that is accessible will dip. Only about half of the money in the fund will be available until the start of the next budget cycle, when the rules will again allow two-thirds of the full balance to be accessed (Figure 1).

Eliminating the “beginning of that biennium” rule would give legislators access to significantly more reserves, particularly in the last 15 months of a biennium. For example, if the rule is eliminated, in June 2011 legislators could access \$359 million of the fund's total projected balance of \$538 million. If the rule is not eliminated, legislators will be effectively limited to accessing only about \$235 million in June 2011, less than half the fund's balance that month.



**Starting in the 2009-11 biennium, most of the time legislators will have access to about half, rather than two-thirds, of the Rainy Day Fund.**

## The Education Stability Fund that isn't

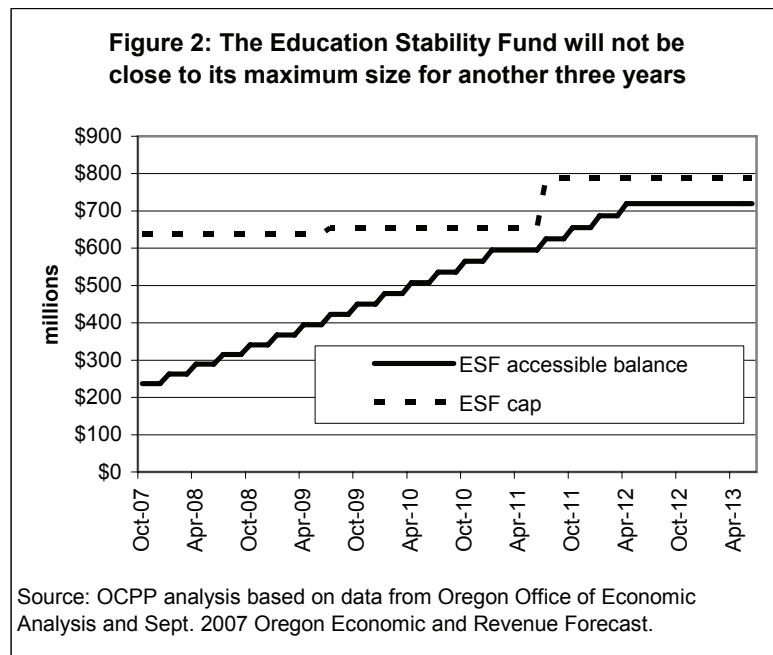
In 2002, in the throes of the last economic downturn, the Legislative Assembly referred to Oregon voters Measure 19, a constitutional amendment to create an Education Stability Fund. Approved by the voters, the measure diverts 18 percent of lottery revenue into the fund until it reaches 5 percent of General Fund revenue in the prior biennium. This fund for public education during a recession or other emergency is small, and its

enabling legislation contains design flaws that slow its growth and limit the Legislature's access to the account.

The 2003 Legislature stripped the fund virtually bare immediately after its creation. Facing a budget shortfall, the 2003 Legislature directed that 90 percent of all lottery transfers to the Education Stability Fund from July 1, 2003, through May 1, 2005, go to the State School Fund.<sup>6</sup> As a result, in May 2005 the Oregon State Treasurer transferred \$126 million that had accumulated in the Education Stability Fund into the State School Fund. This left the Education Stability Fund with an available balance of less than \$3 million, or just 0.03 percent of General Fund revenue in the prior biennium.<sup>7</sup>

The Education Stability Fund has only barely recovered from the actions of the 2003 Legislature. As of October 2007, the Education Stability Fund contains about \$237 million, or just 1.9 percent of General Fund revenue in the prior biennium.<sup>8</sup> If it were allowed to reach its 5 percent maximum cap, it would have \$637 million (Figure 2).<sup>9</sup>

**OCPP estimates that the Education Stability Fund will not reach its maximum allowed size until January 2011.**



Because lottery and General Fund revenue generally increase from one biennium to the next, the Education Stability Fund's cap will likely adjust upward at the beginning of each biennium. OCPP estimates that the Education Stability Fund will not reach its maximum allowed size until January 2011. It will then remain frozen until July 2011, the start of the next biennium. At that point, the fund will be allowed to grow again, until it reaches a new cap of \$788 million sometime around April 2012 (Figure 2).

The fund's slow growth is due, in part, to statutes requiring that all earnings on its investments be transferred into other funds – the Oregon Education Fund (covering debt service on education lottery bonds) and the Oregon Opportunity Grant program (providing need-based scholarships to Oregon higher education institutions).<sup>10</sup>

As a practical matter, the state will always lack full access to the reserves in the Education Stability Fund because some lottery funds are diverted to a sub-account that ties up the money. By statute, 10 percent of lottery transfers to the Education Stability Fund are

credited to the Oregon Growth Account, a sub-account that invests in emerging growth businesses.<sup>11</sup> Money in the Oregon Growth Account already committed to investments is not available in the short term for legislators to spend during a downturn.<sup>12</sup>

### **Oregon's total recession reserves are far from adequate**

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Oregon has not committed enough funds to its two reserve accounts, the Rainy Day Fund and the Education Stability Fund. This basic problem, exacerbated by the design flaws in the two funds, leaves Oregon's public structures exposed to serious disruption in the next, inevitable economic downturn.

At best, if the problems discussed above were corrected, Oregon would have available to spend funds equaling a maximum of just 10 percent of General Fund revenue in the prior biennium. The Rainy Day Fund is capped at 7.5 percent of General Fund revenue in the prior biennium, and with the "can't spend more than two-thirds in any one biennium" rule the effective cap is just 5 percent. Added to the 5 percent allowed in the Education Stability Fund, Oregon would have just 10 percent of the revenue of the prior budget period to spend in the event of a shortfall.

As previously mentioned, during the downturn of 2001-03, General Fund revenue declined by 15.2 percent relative to what legislators expected at the "close of session" forecast in September 2001. As a share of actual General Fund revenue in the prior biennium, 1999-01, the decline was 16.6 percent. Hence, to cover a decline of the same magnitude as the last downturn, Oregon needs reserves totaling *at least* 15.2 percent of projected General Fund revenue for the current biennium, or 16.6 percent of revenue in the prior biennium.

In fact, Oregon probably needs reserves totaling more than that. For one thing, downturns rarely affect just one biennium. For example, when the recession hit earlier this decade, it drove down revenue not only for the 2001-03 biennium but for subsequent biennia as well. Relative to what legislators expected in September 2001, actual General Fund revenue was down 15 percent in 2003-05 and down 9 percent in 2005-07.

Moreover, the decline in 2001-03 would have been worse if legislators had not taken action to limit the damage. The Legislative Revenue Office estimates that, excluding legislative action to raise funds during 2001-03, the revenue decline that biennium totaled 20.6 percent of what legislators expected at the close of the 2001 session.<sup>13</sup>

To be safe and well prepared, Oregon must establish reserves that it can tap totaling a minimum of 15 percent of projected General Fund revenue in the current biennium. Given the small size of Oregon's current reserves, such an expansion would be a significant step in the right direction.

Today, Oregon is nowhere near having adequate reserves. As of October 2007, the total *available* balance of the Oregon Rainy Day Fund and the Education Stability Fund, combined, equals just 1.8 percent of projected 2007-09 General Fund revenue (Figure 3). Even if the Legislature were to fix the "beginning of that biennium" problem, total available funds would equal just 3.5 percent. If the Legislature were also to remove the "can't spend more than two-thirds of the funds in any one biennium" cap, available reserves would rise only to 4.3 percent of projected 2007-09 General Fund revenue. In other words, while the spending limitations create problems, the Rainy Day Fund and Education Stability Fund suffer from the larger problem that the Legislature has not dedicated enough funds to weather the next recession.

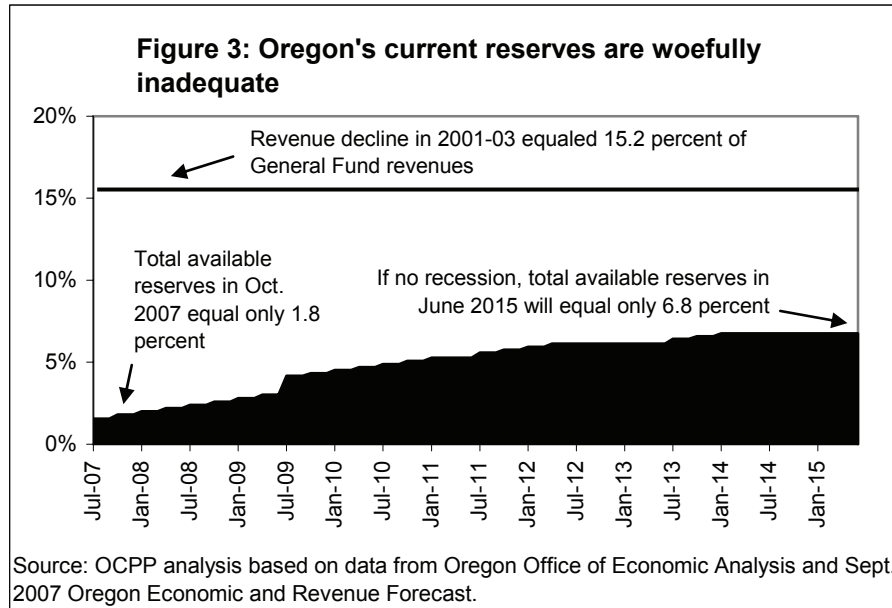
Even in the long term, Oregon's system of reserves is far from adequate. Nearly eight years from now, at the end of the 2013-15 budget cycle, total reserves available for the

**Oregon public structures are exposed to serious disruptions in the next, inevitable economic downturn.**



Legislature to spend from Oregon's two reserve accounts will equal just 6.8 percent of projected General Fund revenue — less than half what was needed during the 2001-03 downturn for just one biennium (Figure 3).

**As of October 2007, the total available balance of the Oregon Rainy Day Fund and the Education Stability Fund, combined, equals just 1.8 percent of projected 2007-09 General Fund revenue.**



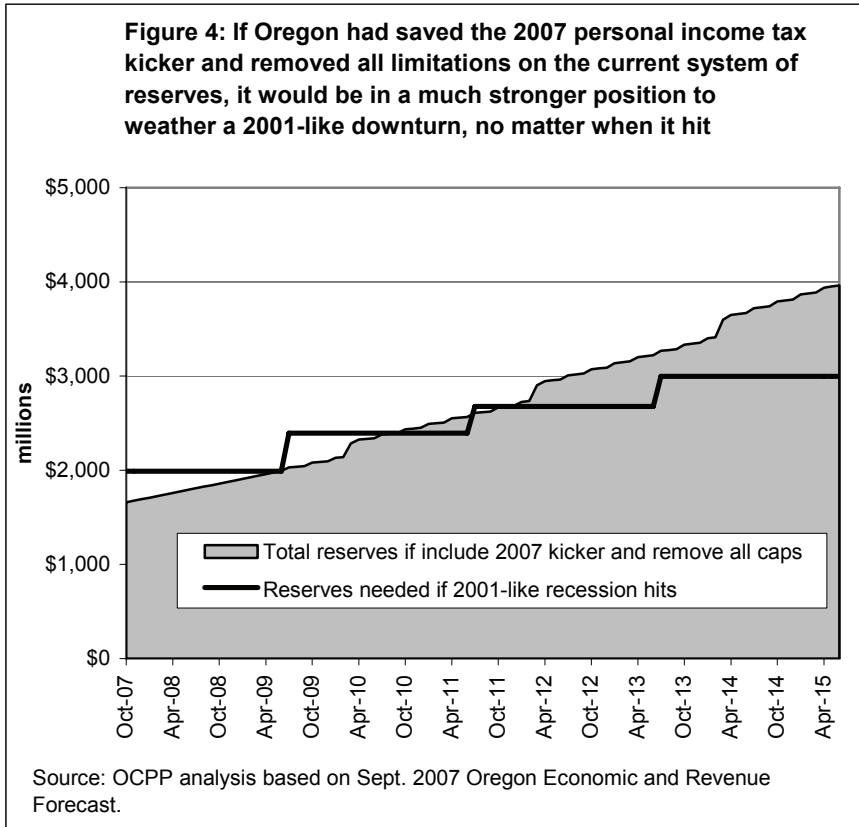
Whenever the next recession strikes, even if it is years in the future, Oregon will be unprepared unless it improves its current system of reserves.

### **The missed opportunity: Oregon's unanticipated revenue**

In fall 2007, Oregon is sending about \$1.1 billion in unanticipated revenue from the 2005-07 biennium back to taxpayers. Had Oregon prudently saved the 2007 personal income tax kicker, as it is called, in the Rainy Day Fund, the state would be much better prepared for the next downturn. If the downturn didn't occur until 2012, Oregon might be fully protected. Here's how:

If a recession of the same magnitude as the one in 2001 strikes Oregon, the state will need nearly \$2 billion to cover the resulting revenue shortfall. As of October 2007, only \$237 million is available in the Oregon Rainy Day Fund and the Education Stability Fund, combined. Despite this shortfall, Oregon will send \$1.1 billion in unanticipated revenue back to taxpayers.

Had Oregon saved this \$1.1 billion for the next rainy day and had the Legislature removed all of the statutory and constitutional limits on the size and accessibility of the Oregon Rainy Day Fund and the Education Stability Fund, reserves in October 2007 would total \$1.6 billion. This amount would still not be quite enough to cover a 2001-like shortfall, but Oregon certainly would be in much better shape to weather a recession (Figure 4). If the recession held off for a few years, until at least September 2010, Oregon's reserves — assuming they included the 2007 personal income tax kicker and faced no access restrictions — would consistently exceed the amount needed to cover a shortfall equal in magnitude to the one that struck in 2001 (Figure 4).



Had Oregon prudently saved the 2007 personal income tax kicker in the Rainy Day Fund, the state would be much better prepared for the next downturn.

## How to save Oregon's future rainy days

Oregon has failed to fund adequately its two reserve funds intended to protect public structures from the worst ravages of an economic downturn. To make matters worse, design flaws restrict the availability and growth potential of the two reserve funds. The Legislature should fix the flaws in the upcoming supplemental session in February 2008.

Specifically, the Legislature should:

### 1. Eliminate the “beginning of that biennium” rule

If a recession hits before the end of the current biennium, legislators should be able to access at least two-thirds of the money in the Rainy Day Fund. In future biennia, legislators should always have access to at least two-thirds of the funds.

### 2. Modify or eliminate the “can’t spend more than two-thirds” rule

Tying the Legislature’s hands with a “can’t spend more than two-thirds” rule on top of the existing “three-fifths majority to spend money” rule makes little sense. If the factors that trigger authority to expend funds are met, the Legislature ought to be able to expend all the reserve funds. The two-thirds rule will be most problematic in the second biennium of a recession. At a minimum, the “can’t spend more than two-thirds” rule should not apply two biennia in a row. Once the two-thirds rule is applied, it should be waived for subsequent biennia.



**3. Allow earnings in the Education Stability Fund to accumulate in the fund and find a different source of revenue for the Oregon Growth Account**

The Education Stability Fund's size and growth are limited because the Oregon Growth Account ties up as much as 10 percent of lottery transfers into the fund and because earnings within the Education Stability Fund do not remain in the fund. Instead, investment earnings transfer to the Oregon Opportunity Grant Program and the Oregon Education Fund.

Oregon could strengthen its reserves — as well as meet the voter-approved constitutional provision that the Stability Fund receive fully 18 percent of Lottery revenues — by finding alternative funding for the Oregon Growth Account. The Growth Account's mandate of making investments in or providing seed capital for emerging growth businesses may not be the most fiscally prudent use of reserve funds.

Moreover, the strength of the Stability Fund would be enhanced if all earnings were to accumulate within the Stability Fund. This change would require finding other revenue sources for the Oregon Opportunity Grant Program and the Oregon Education Fund.

**4. Place unanticipated revenue into the Rainy Day Fund so that reserves can grow in a timely fashion**

Oregon's current system for funding its reserves is inadequate. To reduce the pain of future recessions, Oregon's reserves must be significantly larger. Unanticipated revenue is an obvious source of future reserve funding. The Legislature should refer to voters measures that would transfer future unanticipated personal and corporate income tax revenue into the Oregon Rainy Day Fund, until the fund reaches its funding cap.

**5. Allow the Rainy Day Fund to grow large enough to protect Oregon from a 2001-like recession**

If it eliminates the "can't spend more than two-thirds" rule, the Legislature should increase the maximum allowable size of the Rainy Day Fund to at least 10 percent of projected General Fund revenue in the current biennium or at least 11 percent of General Fund revenue in the prior biennium. This would allow the state to accumulate enough funds between the two reserves to nearly cover a 2001-like recession.

If it maintains the "can't spend more than two-thirds" rule, the Legislature — to protect Oregon during a 2001-like recession — should increase the maximum allowable size of the Rainy Day Fund to at least 15 percent of projected General Fund revenue in the current biennium or 17 percent of General Fund revenue in the prior biennium.

## Endnotes:

<sup>1</sup> Email to authors from George Naughton, Department of Administrative Services, October 3, 2007.

<sup>2</sup> HB 2707, Section 1(4).

<sup>3</sup> HB 2707, Section 4(2).

<sup>4</sup> Email from Paul Warner, Legislative Revenue Officer, September 27, 2007.

<sup>5</sup> We can't help but notice the irony of preventing future Legislatures from draining the fund dry while setting up a fund that effectively leaves it "dry" because they cannot touch the funds until the next biennium. The provision protects the Rainy Day Fund from suffering the same fate the Education Stability Fund suffered in 2005. See "The Education Stability Fund that isn't," below.

<sup>6</sup> HB 3642, 2003 regular session.

<sup>7</sup> Data on Education Stability Fund balance supplied by Office of Economic Analysis and the Oregon State Treasury.

<sup>8</sup> Projection from Oregon Office of Economic Analysis. This \$237 million estimated balance in the Stability Fund does not include funds in the Oregon Growth Account (see footnote 12).

<sup>9</sup> Based on projected General Fund revenue for the 2005-07 biennium of \$12.742 billion, as of the September 2007 Economic and Revenue Forecast.

<sup>10</sup> Under ORS 348.696, the Oregon Education Fund gets three-quarters of the Stability Fund earnings. The Oregon Opportunity Grant program gets the rest. Earnings within the Oregon Growth Account are not included in the earnings transferred to these two other funds, however. Earnings within the Growth Account instead are transferred to the Oregon Commercialized Research Fund, which provides grants and loans to encourage the commercialization of higher education research.

<sup>11</sup> ORS 348.702.

<sup>12</sup> The share of funds in the Oregon Growth Account that have been committed to investments varies substantially over time, since investments occur irregularly and - when they occur - may tie up a large portion of the previously uncommitted cash in the Growth Account. The Oregon State Treasury estimates that currently there is \$18 million in uncommitted cash in the Oregon Growth Account and that typically between \$12 million and \$20 million in the account is uncommitted. In the event of a recession, legislators could quickly access any uncommitted cash, since (unlike investments from the Oregon Growth Account) it would not legally be obligated to investments. Since the precise share of lottery transfers to the Stability Fund that is not easily or immediately available to legislators varies substantially over time, any projection of available reserves from the Stability Fund requires an assumption about how much money will be effectively off-limits to legislators. Moreover, there is no guarantee that the Growth Account will contain any uncommitted cash when the Legislature is seeking emergency funds. OCPP has assumed that a full 10 percent of lottery transfers to the Stability Fund may not be immediately available to legislators, because it may be tied up in Oregon Growth Account investments. This method follows the forecasting method recommended by the Oregon Office of Economic Analysis. The Legislative Fiscal Office estimates that the Stability Fund's balance - including funds in the Oregon Growth Account - at the end of the 2007-09 biennium will be \$472.5 million. The Oregon Office of Economic Analysis projects that the Stability Fund's balance - NOT including funds in the Oregon Growth Account - will be \$395.3 million at the end of the 2007-09 biennium. These two projections taken together suggest that at the end of the 2007-09 biennium the Oregon Growth Account will contain about \$77 million.

<sup>13</sup> Legislative Revenue Office, "Revenue Measures Passed by the 2003 Legislature," Research Report 4-03, October 1, 2003, p. 10.

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This work is made possible in part by the support of the Ford Foundation, the Governance and Public Policy Program of the Open Society Institute, the Stoneman Family Foundation, the Oregon Education Association, the Oregon School Employees Association, and by the generous support of organizations and individuals.

The Oregon Center for Public Policy is a part of the State Fiscal Analysis Initiative (SFAI) and the Economic Analysis and Research Network (EARN).

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